CHAPTER 18
REPORTS ON AUDITED FINANCIAL STATEMENTS

Answers to Review Questions

18-1 An auditor is associated with financial statements when he or she has consented to the use of his or her firm's name in a document such as an annual report.

18-2 Accounting changes can be categorized into changes that affect consistency and those that do not affect consistency. The word "consistency" refers to the application of accounting principles. If a change in accounting principle or in the method of its application has a material effect on the comparability and consistency of the financial statements and the auditor concurs with the change, the auditor should refer to the change in an explanatory or emphasis-of-matter paragraph. Accounting changes that affect comparability but do not affect consistency, such as a change in an estimate or the correction of an error that does not involve a change in accounting principle, are normally disclosed in the notes to the financial statements but do not require an explanatory or emphasis-of-matter paragraph in the auditor's report.

An accounting change can affect comparability but not consistency because an accounting principle can be consistently applied even when the underlying data used to apply it may change. For example, when the estimate of the useful life of a building changes, the company may still consistently apply straight-line depreciation, but the depreciation expense will not be comparable to that of the previous year due to the change in estimate.

18-3 An example of a client-imposed scope limitation is where a client requests that the auditor not confirm accounts receivable because of concerns about creating conflicts with customers. An example of a circumstances-imposed scope limitation is when the auditor is not engaged to conduct the audit until after year-end. Under such circumstances, the auditor may not be able to observe inventory. Auditors should be particularly cautious when a client places a limit on the scope of the engagement because the client may be trying to prevent the auditor from discovering material misstatements. Auditing standards suggest that when restrictions imposed by the client significantly limit the scope of the engagement, the auditor should disclaim an opinion on the financial statements.

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18-4 The concept of materiality plays a major role in the auditor's choice of audit reports. If the departure from GAAP is immaterial, the auditor issues an unqualified/unmodified opinion. If the departure from GAAP is material but not pervasive, the auditor issues a qualified ("except for") opinion. If the departure is so pervasive that its effects are highly material, the auditor issues an adverse opinion. For example, suppose that a client accounts for leased assets as operating leases when proper accounting requires that the leases be capitalized. If a client has only one small piece of equipment that is accounted for inappropriately, the auditor will probably issue an unqualified/unmodified opinion because the item is not material. However, if the client has many significant leased assets that are accounted for as operating leases instead of capitalized leases, the auditor will normally issue a qualified or adverse opinion, depending on the magnitude of the problem.

18-5 The auditor should issue an unmodified report ("unmodified" because Tosi is a private company) on the 2023 financial statements and a qualified report on the 2024 financial statements because the current year is not in conformity with GAAP. The non-GAAP accounting for the lease transaction should be disclosed in the audit report. The opinion on the 2024 financial statements would not be adverse because, while the misstatement is material, it is not pervasive.

Solutions to Problems

18-22 a. The auditor would issue an unqualified audit report with explanatory language for the reliance on the other auditors. In this case, the principal auditor does not intend to take responsibility for the other auditor's work.

b. The auditor should issue a qualified audit report because management has not complied with GAAP. The auditor is not required to prepare the statement of cash flows for disclosure in the audit report.

c. This approach is not in accordance with GAAP because such contingencies must be recognized by an accrual in the financial statements if the amount of the contingency can be reasonably estimated and the loss is probable. A departure from GAAP such as this one requires either a qualified or an adverse opinion, depending on the materiality of the item in question. In this case, the potential settlement is likely to be very large given the proportions of the tragedy in terms of human loss and suffering. In addition, the tragedy may well threaten the company's ability to be involved in similar projects in the future and perhaps its own

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survival. Thus, an adverse opinion is very likely the most appropriate response.

d. Because the client wouldn't allow the confirmations to be sent, the appropriate response would generally be either a qualified opinion or a disclaimer of opinion for a scope limitation imposed by the client's management, depending on the materiality of accounts receivable. However, even if accounts receivable isn't highly material, if the auditor suspects fraud by upper management, the scope limitation would merit a disclaimer.

e. Since the auditor is satisfied about the inventory balance using alternative audit procedures, a standard unqualified audit report can be issued. The alternative audit procedures would normally include a physical count subsequent to year end and reconciliation to the balance at the end of the reporting period.

f. The client's failure to disclose the related party transaction represents a GAAP departure. Since there is a departure from GAAP, the auditor should issue a qualified or adverse audit report depending on the materiality of the matter.

g. Recall that the instructions to the problem indicate the assumption that all matters listed are at least material. Since the change in accounting principle is properly accounted for, the auditor should issue an unqualified audit report with an explanatory paragraph for a lack of consistency in the application of GAAP.

18-23 a. The auditor should issue a standard unqualified/unmodified audit report. It is acceptable for an entity to use different inventory methods in different international regions. Many countries do not allow LIFO, and it can be costly for the entity to maintain inventory records using both valuation methods.

b. The auditor should issue a standard unqualified/unmodified audit report so long as this uncertainty is properly disclosed or accounted for in accordance with GAAP. In this case, a negative outcome for this uncertainty appears to be remote. Therefore, the client is not required to disclose the uncertainty in the financial statements.

c. This is a correction of an error in principle because the use of replacement cost to value inventory is not in accordance with GAAP. The auditor should add an explanatory or emphasis-of-matter paragraph describing the change from replacement cost to FIFO for valuing inventory to the standard unqualified/unmodified report.

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d. This is a change in accounting estimate. Such a change does not affect consistency in the application of accounting principles, and the auditor should thus issue a standard unqualified/unmodified audit report.

e. The auditor should issue a standard unqualified/unmodified audit report because the client corrected the mistake before issuing the financial statements.

f. The CPA is not independent of the company but how the lack of independence should be handled depends on whether Rothenburg is a public company. Under PCAOB standards the auditor should issue a disclaimer for a lack of independence, and the auditor is not allowed to disclose the reasons for the auditor's lack of independence. Under ASB standards (for non-public entities), the auditor will not issue a report unless required to do so by law or regulation, but similar to PCAOB standards, if issued, the report should disclaim an opinion due to lack of independence. However, under ASB standards, the auditor may choose to disclose the reasons for the lack of independence, but if the auditor so chooses, *all* relevant reasons for the lack of independence must be included.

g. If the client refuses to make the adjustment to the loan-loss reserve, the auditor should issue a qualified or adverse opinion because the financial statements will not be in accordance with GAAP. The auditor may also have substantial doubt about the entity's ability to continue as a going concern, which could result in the addition of an explanatory or emphasis-of-matter paragraph to the audit opinion to disclose the going concern issues. If the auditor concludes that there is a going concern problem and the client refuses to disclose the issue in the notes to the financial statements, the auditor's opinion will be adverse.

18-25

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors of Devon Incorporated

Opinion on the Financial Statements

We have audited the consolidated balance sheet of Devon Incorporated as of December 31, 2024 and the related consolidated statement of operations, stockholders' equity, and cash flows for the

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period ended December 31, 2024. In our opinion, except for the effects of not capitalizing finance-lease obligations, and except for not disclosing the change in inventory methods as discussed in the preceding paragraphs, the financial statements referred to above present fairly, in all material respects, the financial position of Devon Incorporated as of December 31, 2024, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Devon Incorporated’s internal control over financial reporting as of December 31, 2024, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 28, 2025 expressed an unqualified opinion that Devon Incorporated maintained, in all material respects, effective internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB. The financial statements of Devon Incorporated for the year ended December 31, 2023, were audited by other auditors, whose report dated March 30, 2024, expressed an unqualified opinion on those statements.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. An audit includes performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the

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overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex audit judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which it relates.

Critical Audit Matters	**Auditor Response**
Inventory Valuation The Company is heavily involved in inventory sales, leading any changes to the inventory account to warrant detailed review from us and the audit committee. During the year, Devon changed its method of valuing inventory from the first-in, first-out method to the last-in, first-out method. This change was made because management believes LIFO more clearly reflects net income by providing a closer matching of current costs and current revenues. Our focus was to validate that the change helped current revenues match current costs, as stated from management's assertion. As seen in Devon's financial statements, the Company's inventory account is material and it is the primary asset that it uses to generate revenue.	We conducted detailed end-to-end walkthroughs of the inventory processes, utilizing Company conducted inventory counts and our own inventory counts to verify that recorded amounts are appropriate. We then conducted testing of inventory values by use of market rates to determine the reasonableness of differences between last-in inventory values and first-in values. In response to the changes in the method of valuing inventory made during the year, we also performed the following: • reviewed the design of the new method to ensure that inventory amounts and prices are properly recorded and will be correctly utilized in valuations going forward • verified with other industry competitors that a similar method of valuing inventory using LIFO is appropriate.
Finance – Lease Obligations The Company is involved in a wide-range of leasing agreements with outside parties. Current leasing standards, according to generally accepted accounting principles, require finance-lease obligations to be capitalized. Our focus was to understand why certain	We confirmed with outside party regarding the amounts and terms of the various finance-lease agreements that the Company was engaged in. The use of positive confirmations allowed for high assurance of the amounts in question and the true structure of the agreements.

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finance-lease obligations were not capitalized and how they should properly be treated. The balance sheet accounts relating to property and debt were impacted as they did not include these finance-lease obligations that should have been capitalized. No disclosure had been made concerning these amounts.	Based on observations and interviews conducted with key accounting personal over these leasing agreements, we gathered evidence regarding the current treatment financing-leases are given.

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Rao, CPA

Rao, CPA

We have served as the Company’s auditor since 2024.

February 28, 2025

18-27

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors of Kim Company:

Opinion on the Financial Statements

We have audited the accompanying balance sheets of Kim Company as of December 31, 2024 and 2023, and the related statements of income, retained earnings, and cash flows for the years then ended. In our opinion, the balance sheets of Kim Company as of December 31, 2024 and 2023, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 2024, present fairly, in all material respects, the financial position of Kim Company as of December 31, 2024 and 2023, and the results of its operations and its cash flows for the year ended December 31, 2024, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Kim Company’s internal control over financial reporting as of December 31, 2024, based on criteria established in *Internal Control—Integrated Framework* issued in 2013 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 12, 2025 expressed an unqualified opinion that Kim Company maintained, in all material respects, effective internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities

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laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

Except as explained in the following paragraph, we conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. An audit includes performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 2022, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 2022, enter into the determination of net income and cash flows for the year ended December 31, 2023

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 2023.

Critical Audit Matters

(No critical audit matters were noted in the problem; however, at a minimum the noted issue with the auditor not taking physical inventory would likely be noted as a critical audit matter. Since this issue is referred to above, this critical audit matter could be cited by reference to the above description).

Friday & Co.

Friday & Co., CPAs
We have served as the Company’s auditor since 2023.
March 12, 2025

18-28 The auditors' report contains the following deficiencies:

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The report should be divided by the main categories:

- Opinion on the Financial Statements
- Basis of Opinion
- Critical Audit Matters

Report title & Address:
- The title should be "Report of Independent Registered Public Accounting Firm".
- Report should be addressed to the shareholders and board of directors.

Opinion on Financial Statements paragraph:
- The opinion section should be first and should also include the first paragraph
- The opinion paragraph references owners' equity while the opening paragraph references the statement of "capital."

Basis of Opinion paragraph:
- The auditor's responsibility to express an opinion on the financial statements is omitted.
- Management's responsibility for the financial statements is omitted.
- There is no mention that the auditor considers internal control in making risk assessments and in designing appropriate audit procedures.
- Reference to assessing "significant estimates made by management" is omitted.
- A statement that they are a public accounting firm registered with the PCAOB is omitted.

Critical Audit Matters paragraph:
- No deficiencies. However, even if no CAMs are identified, the definition should be provided and a statement indicating the auditor determined there were no CAMs should be included. (AS3101.16)

Signature:
- CPA firm's name must be signed
- Must disclose the year that the firm began serving consecutively as the client's auditor.
- The city and state from where the report has been issued should be included

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